AMERICAN BANKER
On Focus and In Depth

Viewpoint: Mortgage Industry Can Expect Tough Few Years

American Banker, Friday, December 30, 2005

By Steinar Ryen and Oliver Sommer

Mortgage companies have been richly rewarded in recent years. Originations have grown a staggering 16% a year, on average, in the 15 since 1990; excluding refinancing the figure is a solid 9%.

Still, originations have been down in six of those years, largely because of refinance volume. Mortgage production peaked in 2003 at $3.8 trillion, driven by $2.5 trillion of refinancing.

It has slipped since then, though this year the total is estimated to be the third-highest ever.

Fueled by refinancing and continued strength in housing markets, the industry has added significant capacity in recent years. Consolidation and the resulting economies of scale have also contributed to profitability; from 1990 to 2003 the top 10 originators went from 17% of the market to 61%, and the top 25 went from 28% to 77%.

Topping off the tide of good fortune has been record-low chargeoffs, which reflect low interest rates, sound economic growth, and ever-rising home prices. At thrifts, for example, troubled assets have steadily declined, from 3.8% in 1990 to 0.34% in this year's second quarter.

But the next three to five years could prove difficult.

To date in 2005, the S&P thrift and mortgage finance index is down about 15%, reflecting reduced production and investor wariness about these issues:

A real estate slump. In a September report the Fed staff argued that housing is less overvalued than traditional measures like price/rent and price/income ratios suggest. More sophisticated ratios using imputed rents show prices to be reasonable, they claimed.

But last year Yale economist Robert Shiller told the Fed that housing prices in major cities showed several characteristics of a bubble.

Mortgage banks had failed to use hedging techniques that would enable them to withstand a prolonged downturn in the housing market, he contended.

September's 20% increase in homes available for sale, along with the highest inventory of new homes on the market since 1996, could mean Prof. Shiller was right. Forecasters at the Mortgage Bankers Association predict a 19% tumble in originations next year as refinancings sag while housing starts and sales of existing homes drop 3.5%.

Should a serious correction occur, demand for home equity products would fall and mortgage producers would be more cautious in offering "exotic" and higher-risk products - for example, pay-option ARMs and interest-only loans.

Given the growth in unconventional products recently and current loan-to-value levels - balances of loans for 90% or more of value totaled almost $25 billion in 2005, 88% more than in June 2004 - a correction could send shock waves through the industry.

In Hong Kong, for example, a plunge in property prices sent the aggregate LTV to 121% in 2003, despite a guideline limiting the ratio in property lending to 70%.

Funding costs. The industry also faces higher costs for traditional deposit gathering. In addition to having to pay higher rates, in the past few years lenders have made unprecedented investments in building branches.

Meanwhile technology, competitive capacity, and product innovation have put pressure on sources of noninterest and net interest income, as exemplified by the now industry-standard "free checking."

The combination of higher expenses and lower deposit fees and yields will keep adding pressure on earnings.

Overcapacity. The MBA estimates that next year refinance volume will fall more than 60% below the 2003 peak. Though some capacity is variable or could be redeployed, instant adjustment to plunging demand is unlikely. And overcapacity would surely put pressure on price and margin.

Credit losses. Finally, it is reasonable to expect that credit losses will trend back toward historic averages. Record-low rates and healthy economic growth helped chop the foreclosure rate of 0.06% of assets. In contrast, the historic rate (from 1967) was nine times higher, at 0.54%. With short-term rates already rising, these conditions are likely to normalize.

Housing prices plummeting. Funding costs skyrocketing. Overcapacity causing irrational pricing. Credit losses mounting.

Even if only one or two of these things happen, the mortgage industry surely has challenging years ahead.

The best that mortgage banks can do right now is prepare for a range of scenarios. Top management has to involve all business units in identifying gaps in the current operating model. Such a discussion could address the operating and performance gaps that might arise from the expected 39% reduction in refinance volume next year.

The second step requires broad employee involvement and continued top-management guidance. Action programs need to be clearly defined; the risks and stakeholder impact must be assessed. (One mortgage originator wanted to capitalize on the increased value of existing servicing rights in a rising rate environment. Evaluating changes in its practice of selling new production instead of holding loans in portfolio enabled it to put a clear plan in place.)

Next, the executive team needs to meet to set priorities so it can implement a plan, usually in 12 to 18 months. (For example, to position itself for a changing environment one regional mortgage bank made it a priority to refine its products for builders of single-family and multifamily homes.)

Finally, though accountability for implementation should be distributed across the organization, it is a good idea for a dedicated implementation team to track it.

We have found that the tracking tools and resources can pay for themselves many times over.

Mr. Ryen and Mr. Sommer are managing directors of Aston Associates, a Stamford, Conn., consulting firm specializing in strategy and operational design.